



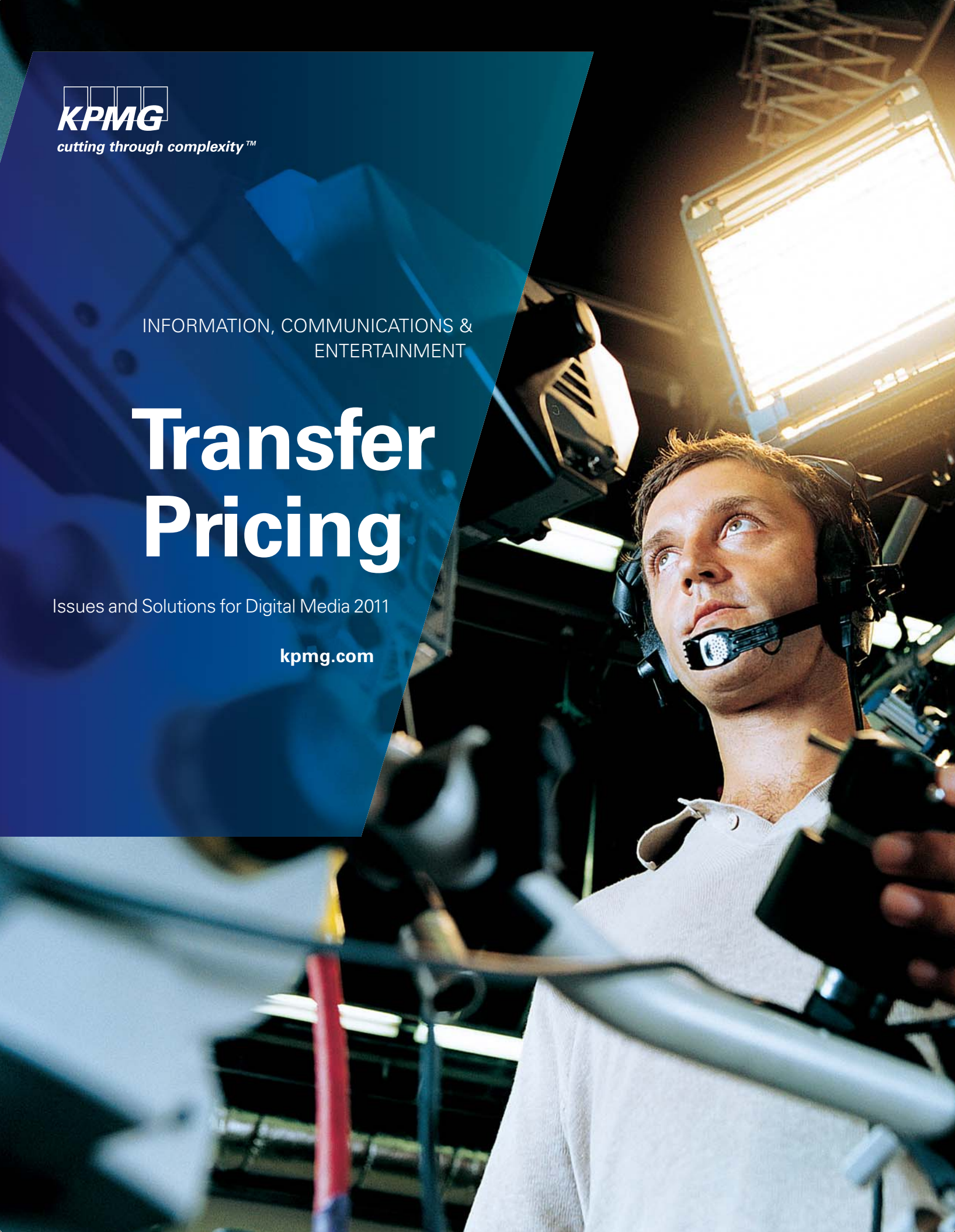
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INFORMATION, COMMUNICATIONS &
ENTERTAINMENT

Transfer Pricing

Issues and Solutions for Digital Media 2011

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“Tax executives find themselves devoting an ever-greater share of their compliance resources to dealing with the transfer pricing implications of globalization.”



“The globalization of the media and entertainment industry, combined with increased regulatory scrutiny and enforcement, has propelled transfer pricing to a new level of importance on the tax agenda.”

Introduction

Tax executives generally agree that regulatory complexity surrounding transfer pricing documentation provides one of the greatest challenges faced by multinational

As the number and scope of

intercompany transactions expand in a global economy, the frequency of tax audits relating to transfer pricing is also increasing. Assessments and penalties resulting from these audits can be significant.

Against that backdrop, an environment

in which intercompany transfers are abundant and intellectual property (“IP”) transactions (typically the most complex of all intercompany transactions) are the norm, tax executives find themselves devoting an ever-greater share of their compliance resources to dealing with the transfer pricing implications of globalization.

This paper will explore transfer

pricing issues within the media and entertainment industry and provide guidance for the pricing of intercompany transactions. It will also cover areas where the tools of the transfer pricing practitioner can assist companies in realizing tax efficient structures through their effect on allocating global system profits to the various segments of the global supply chain and correctly accounting for the intangible assets and significant risks that are common to all segments of the industry.

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This paper is divided into three sections:

- First we set the stage by describing the media and entertainment value chain before and after the advent of digital media technologies.
- Then we detail some of the methodologies available for setting transfer prices and testing compliance with the arm’s-length method.
- Finally, we discuss some of the unique issues that companies in the digital media market are now facing.

The complex digital media value chain



The media industry is complex and diverse, so we should define the types of companies referenced when we use the terms media and entertainment. Are we referring to traditional media companies like radio and television broadcasters, recorded music and filmed entertainment, advertising and direct marketing, book magazine and newspaper publishing and movie theater exhibition, or are we referring to digital media content creation, aggregation, distribution, and even mobile applications? For purposes of this paper, we are referring to both. While the old and new creation and distribution channels employ different business models, they share a significant common denominator: content is a key value driver for the business. Whether we are talking about the creation, production, aggregation or distribution of content, media companies typically engage in one or more of these three functions within the content delivery supply chain.

It may make sense to define the media supply chain more systematically before moving on. As a word of caution, however, the simple act of defining the media supply chain entails risks; the supply chain for media companies is changing so rapidly that little time will pass before what is written becomes outdated. Nevertheless, we will endeavor to set some parameters for discussion. Specifically, we will look at the evolution of the media industry supply chain over time to assist in setting the stage for digital media and aggregation trends.

The historical ‘analog’ environment of media & entertainment

A common denominator that will determine value for all participants in the media industry is content. The creator of content (whether captured on film, in music, in a video game, mobile application or in print) owns a valuable asset whose value can be realized when brought to market in an efficient and effective manner.

Film, for instance, has historically been brought to market via well-established channels. In the past, a network of

theatrical distributors (mainly the major studios) released the product for viewing in theaters.

Then, after a period of time, the film was sold on DVD/ Blu-ray for home entertainment purposes. Eventually the film was also available for viewing on premium pay TV channels, and ultimately free TV after other revenue channels were exhausted. The recorded music industry followed a similar path. Records or CDs were mass produced, promoted on terrestrial radio and sold to consumers via retail channels and other outlets. And the value chain for video games was similar to that of music and home entertainment in that content was traditionally sold to end users through retailers. Print, one of the oldest forms of media, was traditionally sold to the consumer on a subscription basis or through a local newsstand / bookstore. As such there were significant physical and financial barriers to entry into the various media markets, and the companies that served as the gatekeepers to accessing these media spaces were, for example, the major studios (for film), major publishers (for print), and record labels (for music).

The new world of digital media content and transformation

New digital paths to bring media content to market have changed the industry forever. Despite a growing population, TV and radio audiences have declined in the U.S. According to The Numbers, a box office data source provided by Nash Information Services, LLC, movie ticket sales peaked in 2002, and magazine and newspaper circulation has been trending lower for over half a decade, with revenue and earnings growth stagnating.¹ Conversely, from 2000 to 2010, the percentage of North American population using the internet increased over 140 percent, with 77 percent of the population possessing internet access in 2010, according to Internet World Stats, and two-thirds of the world’s consumers are now using cloud computing applications and services.² In addition, according to eMarketer Digital Intelligence, the

¹ For example, The Boston Globe, a newspaper with a 137-year daily tradition, shows signs of closing its doors in the near future, while the Christian Science Monitor, one of America’s most respected newspapers, has already suspended its daily print edition.

² KPMG Consumers & Convergence IV Survey, 2010.

average time spent online per day among U.S. consumers is nearly two and a half hours.

According to Internet World Stats, internet growth in other parts of the world is even more dramatic, with Asian and European internet usage having grown at rates of 568.8 percent and 305.1 percent, respectively from 2000 to 2010. Internet usage growth is especially prominent in Asia, where users spend even more time visiting websites than U.S. users.³ According to Forbes.com®, China overtook the U.S. as the leader in internet usage in 2006, despite having fewer households with internet access.

“The rapid consumer adoption of wireless smart devices (smart phones, tablets, PC hybrids and even automobile based devices) combined with the explosive growth in mobile applications is allowing consumers to do almost anything they do on line on their mobile devices.”

Also, according to KPMG’s global survey, Consumers & Convergence IV, nearly three times as many people shopped at retailers’ websites in 2010 than in 2008.

These trends also have a significant effect on online advertising. Global online advertising increased from miniscule levels in 2000 to approximately US\$25 billion in 2005 and is forecast to grow to more than \$55 billion by 2010.⁴ This channel is the fastest growing of all direct marketing channels, driven largely by advertisers’ desire to tap into the rapidly growing online retail market. In addition to providing another way to target and reach consumers, the internet offers the transparency and accountability that advertisers seek. Web masters can track the number of “page views” — connections made to a website over the internet or another network — on a given site. In addition, search engines can be used to monitor the kinds of searches viewers conduct, generating valuable consumer data. For example, a Web surfer interested in airfares is also

likely to want information on hotels at the requested destination and perhaps rates on car rentals. A job seeker may be interested in professional training opportunities. Tracking search patterns enables advertisers to target their ads more effectively.⁵

Wireless is also an expanding area for media content distribution and consumption. The rapid consumer adoption of wireless smart devices (smart phones, tablets, PC hybrids and even automobile based devices) combined with the explosive growth in mobile applications is allowing consumers to do almost anything they do online on their mobile devices. As a result, the delivery of media content to mobile devices is surging, and mobile advertising and marketing will follow. But according to KPMG’s Consumers & Convergence IV survey, not all content is equal, and those that will pay for content prefer to pay for only portions of a site. Entertainment content, such as games, video and music, has a perceived premium for survey respondents.

So what do these changes mean from a transfer pricing perspective? Analog media revenue and distribution channels are being replaced in many cases by their digital media counterparts and new business models are emerging at the expense of analog channels. Competition for consumers’ entertainment dollars (including advertising and marketing value) has become increasingly fierce, with many new entrants in the market.

Some suggest that certain digital media innovations reduce the value of content and the companies that create it, making it easy to access without paying the toll charges levied by traditional media sources. Search engines, for instance, allow web surfers to find free content that might otherwise have been sold in the analog media world. Certain peer-to-peer networks enable users to illegally download copyrighted music and video content. YouTube® streams more than 2 billion free videos per day. At no charge,

³ Internet World Stats, Miniwatts Marketing Group, www.internetworldstats.com

⁴ Oppenheimer & Co. Inc, January 2007, The Digital Consumer: Examining Trends in Digital Media

⁵ Standard & Poor’s Industry Surveys, James Peters and William H. Donald, “Advertising,” August 9, 2007

⁶ http://www.youtube.com/t/press_timeline

Google® users can download and print books.⁶ However, the internet also enables media companies to reach new customers and generate revenue from content in new ways.

One of the earliest segments to struggle with digital transformation issues was the music industry, with consumer preference migrating towards online digital music content delivery. We now know that consumers have increasingly acquired recorded music via their personal computers (PCs) and other wireless handheld devices, such as smartphones and iPad's, which also may involve subscription or pay-per-download services. According to Standard & Poor's Industry Survey, during the first half of 2010, digital album sales rose about 13 percent, to about 42 million units, outweighed by a continued steep drop of 18 percent in CD album sales, to 110 million units. Digital music accounted for 40 percent of all music sales in the U.S., with digital albums comprising about 27 percent of all album sales.⁷ And although digital sales are outpacing non-digital sales, the conversion to digital is causing a sharp decrease in sales by music labels, continuing the decade long pressure on the music business to successfully transform itself.

Print publishing is facing similar challenges in the digital transformation process. As evidenced by the dramatic decline in newspaper subscriptions, the book, magazine and newspaper publishing business must find new digital distribution revenue to replace declining analog revenue streams. Some in the industry's subdivisions are resilient and are finding new success with digital reader content channels (for example Amazon.com®'s Kindle™ and Apple®'s iPad®), for which audiences are growing and titles are expanding. Other magazine titles such as Newsweek or newspapers such as the Denver Post have gone into bankruptcy or have been sold when new digital revenue streams could not be found.^{8,9} It is clear for most

in the publishing business that new business models and investment in digital distribution channels are essential to future success.

The film industry faces similar issues as the industry migrates towards digital distribution to theaters and homes. Executives face the question of how to adapt traditional business models to address the opportunities and challenges presented by the continuing evolution of content distribution channels, amid shifts in consumption patterns and other changes wrought by technological advances. Facing the saturation of traditional channels, video content providers seeking to maximize their investments are increasingly experimenting with new distribution opportunities. Amid increased audience fragmentation, several new channels have emerged in recent years to provide additional outlets for video content distribution. These include electronic sell-through outlets, such as Apple Inc.'s iTunes®, Amazon.com, Inc., WalMart® Stores, Inc.'s Vudu®, and Microsoft® Corporation's Xbox Live®; video-on-demand (VoD) services from traditional cable and satellite TV providers; streaming and subscription-based DVD mail-order services such as Netflix, Inc.; and DVD rental kiosks such as Coinstar, Inc.'s Redbox®.¹⁰

And, finally, there are the aggregators of media content. These are the new age entrants like iTunes, Google, Yahoo®, YouTube and others that aggregate media for the consumer. These aggregators are better positioned to exploit a new internet advertising model (because of their substantial online traffic, technology infrastructure, and expansive network of advertisers and web publishers) than their old media counterparts. As consumers become more dependent upon an array of digital services to get them through the day, consumer awareness of the capabilities of the medium and the large number of available multimedia content and service providers grows exponentially.

Indeed, the mere fact that consumers now glide between cellular, home phone, PC and home entertainment systems has created an appreciation for both the benefits and the limitations of convergence. Media aggregators are prepared to satisfy the consumer's appetite through offering a wide variety of content over a single platform in return for either (i) a subscription fee or a fee for downloads (for example, iTunes) or (ii) advertising revenues (for example, YouTube).

The online advertising model involves a website that provides content (usually, but not necessarily, for free) and services (like email, IM, blogs) mixed with advertising messages in the form of banner and/or streaming ads. The ads may be the major or sole source of revenue for the site, which may be a content creator or a distributor of content created elsewhere. The advertising model typically works best when the volume of viewer traffic is large or highly specialized. Under the subscription model, users are charged a periodic – daily, monthly or annual – fee to subscribe to a service. It is not uncommon for sites to combine free content with "premium" (i.e. subscriber- or member-only) content. Subscription fees are generally incurred irrespective of actual usage rates. Subscription and advertising models are frequently combined. Finally, a web-based merchant such as iTunes deals strictly in digital products and services and, in its purest form, conducts both sales and distribution over the web.¹¹

7 Standard & Poor's Industry Surveys, Tuna N. Amobi, "Movies & Entertainment," September 9, 2010

8 US Tycoon Sydney Harman Buys Newsweek 'for a Dollar', The Guardian, August 3, 2010

9 Denver Post Owner Plans Bankruptcy Filing, The Washington Times, January 16, 2010

10 Standard & Poor's Industry Surveys, Tuna N. Amobi, "Movies & Entertainment," September 9, 2010

11 "Business Models on the Web," Michael Rappa, January 17, 2010,

<http://digitalenterprise.org/models/models.html>.

Section 2 of this paper provided a high level summary of the digital media industry supply chain, and section 3 will introduce the role of transfer pricing issues in digital media. In particular, we will review what tools are available to the transfer pricing practitioner in determining whether companies engaged in the industry have set their prices for intercompany transactions in a manner that complies with the arm's-length standard. The globalization of the media and entertainment industry, combined with increased regulatory scrutiny and enforcement, has propelled transfer pricing to a new level of importance on the tax agenda.

Most of the countries that currently have transfer pricing requirements are placing increased focus on enforcement and are demanding enhanced documentation of intercompany transactions and transfer pricing-related activities. In addition, as taxpayers become increasingly sophisticated in their management of international tax dealings, tax authorities are ensuring that their auditors are well versed in the technical aspects of transfer pricing. Tax executives at multinational enterprises know that if intra-group transactions are not conducted on an arm's-length basis, or if that basis is not properly documented, the associated tax cost can be compounded through

Transfer pricing: The statutory compliance perspective

“Most of the countries that currently have transfer pricing requirements are placing increased focus on enforcement and are demanding enhanced documentation of intercompany transactions and transfer pricing-related activities of content to meet various local requirements.”

“Companies must recognize that tax is not an issue that the tax department can deal with in isolation from the rest of the business.”

(i) the investment of internal management resources, (ii) the incurrence of professional fees, and (iii) the addition of penalties, associated with unsuccessfully defending the company’s transfer prices from challenges by tax authorities. As stated above, these authorities have become increasingly sophisticated and aggressive in their examination of transfer prices. And, as most tax executives would concede, it is generally far less efficient to make adjustments at the tax return stage than ensuring that the subject transactions reflect arm’s-length pricing in the first instance.



Internal controls:

The gatekeeper for transfer pricing compliance

How do you know that transactions have been priced in accordance with the arm’s-length principle? If transfer prices are set using management accounts, are they reflected in the statutory accounts at arm’s-length? Is the tax department always aware of the transfer of goods, services, IP, and financial support between entities? And how are the risks associated with transfer pricing policy and process implementation managed within the company? These are some of the key questions that companies should ask when assessing the adequacy of the internal controls and processes that govern their transfer pricing arrangements. Companies must recognize that tax is not an issue that the tax department can deal with in isolation from the rest of the business.

Tax departments need to possess a thorough understanding of the manner in which the group conducts its business, including the nature of all transfers between its various entities. If the need to establish adequate internal controls is not acknowledged by the boardroom, tax controversies will ultimately arise that will needlessly consume an enterprise’s resources.

Transactions will be consummated without tax department input; those transactions will frequently be structured inefficiently for tax purposes, increasing the cost of doing business in a competitive global environment. This is a particularly significant risk when dealing with IP, where it is often more difficult for the business to recognize that a taxable transfer has taken place.

Successful implementation requires, among other things, an increased focus on ensuring that the tax function is successfully integrated into the business so that tax risks in general, and those risks associated with transfer pricing in particular, are properly managed. However transfer pricing controls are not limited to the functions of the tax department but rather span the entire organization. Examples include monitoring the correct accounting implementation of the transfer pricing policy, maintenance of proper intercompany agreements and documentation, and integrating intercompany pricing with performance evaluation metrics, which can become problematic when employing profit based methods in a company that evaluates management based on bottom line results.

Accounting Standards Codification (“ASC”) 740-10 and Uncertain Tax Positions (“UTP”)

In addition, multinational enterprises are also facing tougher transfer pricing reporting issues at a time when companies are subject to more rigorous controls and risk management such as ASC 740-10 and the IRS’ new schedule for Uncertain Tax Positions (“UTP”). As part of the process of compliance with ASC 740-10 or preparing the UTP schedule, it is critical to identify transfer pricing risks that may arise in relation to the prices charged for intercompany transactions and to make certain to have established or documented the arm’s-length nature of such prices. As transfer pricing has risen on the priority rankings of taxing authorities throughout the world, the arm’s-length nature of a company’s intercompany transactions may increasingly come under heightened scrutiny by tax authorities on both sides of the transaction. Additionally, often evolving legislative and regulatory environments in various countries create an ever greater need to revisit transfer pricing policies on an annual basis. It is therefore now more crucial than ever to maintain thorough transfer pricing documentation controls and processes that serve as a pre-emptive tool and first line of defense in case of a tax authority inquiry.

Implementing the arm’s-length standard:

What is an acceptable method of analysis?

A transfer pricing model is the mechanism employed by a company to implement arm’s-length pricing for goods, services, IP, and funding. It provides the platform on which transfer prices are analyzed and, in particular, on which compliance with the transfer pricing rules is tested. International transfer pricing consensus and local regulatory regimes such as the OECD Guidelines and Section 482 of the U.S. Internal Revenue Code specify authorized transfer pricing analysis methods. Those methods take into account the functions performed and risks borne by each party to a related party transaction, as well as the economic conditions in each participant’s geographic market. The arm’s-length principle requires that related parties price their intercompany transactions in a manner that produces an outcome similar to that which would be obtained if the same transaction had been consummated between two unrelated enterprises. As previously mentioned, the expected outcome is dependent upon both the functions performed and the risks borne by each party, together with the market conditions faced by the transacting parties.

Tax administrators frequently raise issues related to asymmetries between a firm’s transfer prices and the risk profiles of the transacting parties. Such asymmetries may include, for example, the assignment of entrepreneurial profits to an entity – possibly in a low tax jurisdiction – that does not, in practice, perform substantial entrepreneurial functions or bear the related entrepreneurial risks.

Transfer pricing methods are often divided into two broad categories: (1) traditional transaction methods, and (2) transactional profits methods. We will discuss below some of the more common transfer pricing approaches available in each of the categories.

Traditional transaction methods

Traditional transaction methods

compare the prices of intercompany transactions to the pricing of similar transactions between unrelated parties. The three internationally accepted transaction methods are comparable uncontrolled price, cost plus, and resale minus.

Comparable uncontrolled price (CUP)

The CUP method looks directly at

prices themselves.¹² For instance, a producer might license content to a related distributor while also licensing the same (or similar) content to unrelated parties. If the terms of the two transactions meet fairly stringent standards of comparability (or are susceptible to the computation of reliable adjustments for those features of the two transactions that are not comparable), the prices charged to the unrelated parties would provide an arm’s-length benchmark for the prices charged to the related party distributor. Unfortunately, it generally is difficult to obtain CUPs for all the different types of transactions undertaken by related parties. While it is relatively easy to identify comparables for theatrical distribution and advertising sales transactions, it is far harder to locate reliable CUPs when the tested transactions involve services, production, or IP.

In the media industry, there is an abundance of market evidence to assist in benchmarking the appropriate returns for theatrical distribution. It is common industry practice to strike independent deals between producers and distributors, although the risk profiles of the distributors can vary greatly. This makes it easier to match the desired risk profile of your tested party to a third-party comparable. In some cases, distributors take on a great deal of risk in marketing a film. In others, the distributor assumes very little risk. In performing a CUP analysis for theatrical distribution, the challenge is to understand each of the potential CUPs and be very deliberate in reviewing the intercompany

¹²The OECD Guidelines identify the CUP method as an accepted test for tangible and intangible property as well as service transactions. The U.S. regulations, however, provide two alternative methods, the comparable uncontrolled transaction (“CUT”) method for testing of intangible property transfers, and the comparable uncontrolled service price (CUSP) method for the testing of services. The CUT and CUSP methods, however, are functionally equivalent to the CUP method, with minor modifications to reflect the transaction-specific application of the methodology.

agreements to ensure that the risk profile of the related party distributor is consistent with that of the unrelated distributor used to construct the CUP. In addition, the unique nature of the content should be carefully considered because factors such as genre, box-office success, duration (among others) can have a significant impact on the comparability of potential CUPs. Matching the risk profile of the production activity to the tested party can be quite difficult; a detailed best method discussion is highly recommended.

Cost plus and resale minus

The cost plus method looks at the mark-ups over cost charged in transactions between unrelated parties to establish an arm's-length benchmark for mark-ups in related party transactions. The resale minus method focuses upon the end sales price to a third-party and deducts a 'gross margin' to arrive at the intra-group purchase price for the product or service. These methods are not widely used by companies in the media and entertainment industry since they have to be applied on a transaction-by-transaction basis and it is difficult to identify sufficiently comparable transactions between third parties that provide reliable benchmarks within the industry.

Where available, many tax authorities prefer the use of these "traditional" transactional methods.¹³ Because the standard of comparability for such methods is relatively high, however, the wide array of transaction types, terms, risk assignment, and functional differences makes transactional methods difficult in practice to apply. Many companies use transactional transfer pricing methods to set intercompany prices. In practice, however, traditional transaction methods are often tested (or supported) by profit-based methods due to the burden imposed by most tax authorities on transaction-based testing.



“MNEs are also facing tougher transfer pricing reporting issues at a time when companies are subject to more rigorous controls and risk management of content to meet various local requirements.”

¹³The OECD has historically employed a hierarchical approach, assigning preference to transactional methods over profit-based methods. On July 28, 2010, however, the OECD Council approved a revised version of the OECD Guidelines that replaced the automatic preference for transactional methods with the selection of the “most appropriate method,” similarly to the best method selection of the U.S. Regulations.

Transactional profit methods

While traditional transaction methods are often preferred, at least in theory, by tax authorities, transactional profit-based methods are far more commonly applied by both taxpayers and tax officials to validate compliance with the arm's-length standard. The OECD Guidelines and the majority of national regulatory regimes define two transactional profit-based methods: (1) the transactional net margin (or comparable profits) method, and (2) the profit split method.

Transactional net margin (or comparable profits) method

The transactional net margin method (OECD Guidelines) and the comparable profits method (U.S. Treasury Regulation § 1.482-5) compare the profits of a legal entity (or a segmented activity within that entity) to comparable independent companies performing similar functions with comparable risks. When applying this method, the entity that is selected for the comparable company analysis (i.e. the tested party) is typically the least complex entity involved in the transaction. Consequently these methods can be

“While tax authorities may in theory have a preference for traditional transaction method, in practice, profit-based methods are often the simplest to apply and frequently provide the more reliable measure of an arm’s-length price.

applied to benchmark an arm's-length profit for low risk entities or functions such as limited risk content distributors. As previously stated, while tax authorities may in theory have a preference for traditional transaction methods, in practice, profit-based methods are often the simplest to apply and frequently provide the more reliable measure of an arm's-length price.

Profit split method (PSM)

There are several variations of the PSM. The comparable profit split method, a method described in the U.S. transfer pricing regulations, splits the total system profits from a controlled transaction in the same proportion as the split observed in a comparable transaction between

unrelated parties. The contribution profit split method, a method included in the OECD Guidelines, splits total system profits between controlled participants based on a contribution analysis that identifies the contributions of each of the controlled parties to the profit-generating activity. The residual profit split method (RPSM) is a hybrid method that (i) assigns a market return to each party to the controlled transaction through applying one of the other transaction- or profit-based transfer pricing methods (to the extent that the party performs routine functions subject to market benchmarking), and (ii) allocates residual profits (profits in excess of the sum of the routine profits assigned to each of the parties) among the parties based on the value of each participant's non-routine contributions to the tested transactions.

Applications of the comparable profit split method are rare. The RPSM, or the contribution profit split from the OECD perspective, however, is a method frequently used by both taxpayers and tax authorities. The greater acceptance of the RPSM may be attributable to the fact that it begins by solving for the known (assigning routine returns to each party based on functions performed and risks incurred using familiar market benchmarks), prior to allocating the unknown (those returns which are not susceptible to market benchmarking) to each of the parties. The residual profit is divided among the parties based on their non-routine contributions to the tested activity.

The RPSM may be used when both parties to the transaction contribute valuable non-routine intangibles and it is difficult to find market benchmarks for the value of this unique IP. Therefore, it becomes difficult to assign a market return to the respective owners of unique (or non-routine) IP. When applying the RPSM, any profits (or losses) remaining after routine returns have been subtracted from the combined system profit of the parties to the tested transactions are assumed to be attributable to the contributions of the IP, and are divided among the parties based on the relative value of their investments in the relevant IP.

“As transfer pricing has risen on the priority rankings of taxing authorities throughout the world, the arm’s-length nature of a company’s intercompany transactions may increasingly come under heightened scrutiny from both sides of the transaction.”



In that manner, the non-routine profits (or losses) are attributed to the asset that is deemed to have produced them (the non-routine IP).

The RPSM may also be used when one entity owns an intangible asset (the developer or purchaser of the asset) and the other entity assumes certain risks related to its utilization (exploits the asset), and the comparable profits method cannot be applied due to a lack of market benchmarks for either party. The profits deemed attributable to the intangible asset are then split between the licensor and the licensee. The RPSM, therefore, may be appropriate in the media and entertainment industry when content owners license their content to

affiliates for distribution, and when the functions of either party as they relate to the exploitation of the intangible cannot be appropriately benchmarked with third-party comparables due to the unique nature of the IP. While the RPSM can be used in such instances, because it does not directly benchmark a specified intercompany royalty rate due to the difficulty of finding market benchmarks for the relationship between the licensor and the licensee, the RPSM is often better employed as a supporting method than as a primary method. To the extent that a more direct method is available (i.e. the CUP method), it would usually provide a more reliable benchmark than the RPSM.

The emergence of the new digital media paths to market creates an array of new transfer pricing issues. While the issues surrounding the creation of content remain largely unchanged, the various new distribution channels provide a whole host of new issues and considerations when evaluating the conformity of prices to the arm's-length standard.

The functional profile of digital media content creation is relatively unchanged from the traditional media model; the production of content has not evolved as rapidly as the new distribution mediums. The most significant factors impacting transfer pricing for media content creators, both traditional and new, are (i) the increased globalization of production (especially motion pictures), and (ii) the high risks associated with investing in content. Each new investment, apart from sequels and other special circumstances, creates a unique intangible.

Evolving Landscape for Motion Pictures *Production*

Film production is a risk-laden activity. Many movies fail to attract an audience, ultimately losing money. But those films that are successful can be quite profitable. From a transfer pricing perspective, the relative risk of the investing activity can create an opportunity for the centralization of entrepreneurial risk (with the potential to attract high profits – but also the risk of having losses). Further, since few films rely on existing production intangibles, each film's risk may be assessed separately and there may not be any existing intangibles requiring compensation when migrating functions and centralizing risk. Exceptions to this general statement include sequels to highly successful projects. In the past, most production occurred in the U.S. and the risks of the production were centralized in the U.S. Premium production profits from hit movies had

Transfer Pricing Considerations for Traditional and Digital Media

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to be returned to the U.S. via the company's transfer pricing. While Hollywood once had a majority share of the production for the U.S. theatrical market, a growing number of locales are attracting film production with tax incentives and other enticements and Hollywood is losing market share. In fact, many big budget films are now filmed entirely outside the U.S. This creates an opportunity for development of IP associated with the production process outside of the U.S., which would in turn result in the residual profits and losses attributable to the offshore territories.

Marketing

Marketing a film at the theatrical level

remains enormously important. The first step to successful distribution of content is an embedded network that enables its owner to distribute content globally. While content is the most valuable IP in the media business, the value of that content cannot be realized without access to a distribution network capable of bringing the product to the consumer. Many media distributors also help generate brand value of the various players involved in content production. It is not uncommon for a company to spend as much on the marketing of a film as on its production, and utilize synergies from the success of one title to promote another title from the same writer, director, or even production studio. Since the success of the film is still unknown at the time that the distributor invests in promotional activities, the risks associated with marketing expenditures are high. Selection of the party that invests in significant marketing expenditures provides planning opportunities similar to those identified for the funding of production. While marketing expenditures are often funded locally, they can be centralized at a tax efficient location, which could factor into shifting the risk and accompanying entrepreneurial profit or loss opportunities from the local affiliate to a centralized location. There are a significant number of third-party marketing deals that should be considered when benchmarking arm's-length returns for distribution and marketing. While those deals may provide evidence of market behavior, they require a thorough analysis and consideration of all of the relevant

comparability factors prior to accepting or rejecting them as comparable transactions.

Practical Considerations

Though the planning opportunities described above are quite interesting, there are a number of issues that must be considered when documenting intercompany prices related to film production. First and foremost is that the comparable profits method is typically unavailable due to the absence of public companies performing only production. Most pure production companies are private, and those that are public display wide variations in profitability. This makes it quite difficult to benchmark a return for the production activity. CUPs are also difficult to identify. Though there are numerous third-party pure production agreements, they tend to be stripped-risk production contracts with very low returns. It is therefore difficult to obtain sufficiently comparable transactional or profit-based benchmarks using the production company as the tested party.

NetworkTV

Transfer Pricing Challenges

Similar issues arise from content

creation for network television which is often decentralized and transferred between various affiliated networks. For example, local content may be

created in one country but broadcast throughout affiliated networks within the region or world. This occurs in both entertainment and news networks and poses a significant transfer pricing challenge in that these transactions represent only one component in the overall value of the network. Assigning an arm's-length value to this locally-produced content is difficult because profit must be allocated among the content and the other functions that contribute to the operations of the network. In addition, the transfer of content between affiliated networks can include the bundling of several programs or the bartered exchange of one program for another.

Asia Snapshot

- **Increasing research and development incentives and IP protection** in the Asia-Pacific region has led to a trend of companies migrating their IP, traditionally based in the U.S. or Europe, into the Asia-Pacific region.
- **Economic development in the Asia-Pacific region** has led to a growth in the offerings of the media market. Customization and localization of media content for the region has been increasing, including voice dubbing, subtitling, and censorship of content to meet various local requirements. Such customization and localization is being carried out both locally in the country where the content is being broadcasted, as well as being regionally centralized (e.g. for South-East Asia, North Asia, etc).
- **While Bollywood is the best known segment of the Asian media industry**, there is an increasing trend of content production in the Asia-Pacific region. This has also given rise to more local production support services being provided.

“There are a significant number of third-party marketing deals that should be considered when benchmarking arm's-length returns for distribution and marketing.”

As with theatrical content, CUPs are not normally available for content production, making direct measurement difficult and pricing potentially less precise. These factors must be considered when designing or testing a transfer pricing policy for television network created content.

Planning Opportunities

However, the complexity of network content production does not prevent networks from considering planning opportunities. Since many networks

consumer the option to pick and choose content that might otherwise be bundled. In contrast, the advertising model is geared at attracting the largest audience in order to leverage ratings to attract advertisers. These differences in the value driver between the distribution models creates a rift in the availability of market comparables, and in applying the transfer pricing methods one should consider these differences when selecting both the appropriate method and comparable benchmarks.

traditional transactional approaches, but in either case a thorough best method analysis is vital to establishing a robust and defensible transfer pricing policy.

Another new technology that is affecting the media industry value chain is the increased use of DVRs, permitting network TV viewers to digitally record TV shows and view them at their leisure. The technology allows consumers to fast forward past advertisements, which diminishes the value of advertising in the supply chain. A common mechanism to counter this trend is product placement advertising in which products are strategically embedded within content. When this occurs, how does one bifurcate value between content and advertising? How should the two revenue streams be divided? Again, these are interesting considerations that companies in the industry must address.

“The emergence of new media and media aggregators produces a plethora of unexplored transfer pricing issues...distribution of content is a critical element in the new media value chain and typically has significant valuable intangibles associated with it.”

produce local content in many locations throughout the world, the risk associated with this content is distinct from the risks borne by the parent company. The risk associated with local production activities can be centralized and funded out of one country to increase efficiency and improve the management of the risk.

Digital Media Implications

The emergence of digital media and media aggregators produces a plethora of unexplored transfer pricing issues. Similar to the old media supply chain discussed above, distribution of content is a critical element in the digital media value chain and typically has significant valuable intangibles associated with it. Currently, there are three revenue-generating distribution models employed by digital media: (1) a subscription-based model, (2) a direct pay-per-use model and (3) an advertising-based model. In employing the subscription model, the distribution strategy is to differentiate the product offerings as “premium content” which would justify the consumer paying a fee to obtain access to such content. The direct pay-per-use model gives the

Changing Value Chain

Regardless of the distribution model employed, the new era of digital content distribution expands the media value chain. Previously, the value drivers were the producers of content and the respective distributors. Now there is an additional participant, the media aggregator, who is entitled to a share of the overall profit pool. But how is that share determined? Within the media value chain, what functions are non-routine and which are routine? In valuing the contributions of the various participants in the chain, which should be given greater weight: (i) the content, (ii) the distribution intangibles (the network and marketing IP), or (iii) the aggregator’s IP (brand name and online distribution technology)? What are the relative values of each of these functions? These are some of the issues that digital media companies must face when setting transfer prices. Care should be taken to properly allocate profits in a manner that is consistent with the arm’s-length standard. This can be accomplished through applying the RPSM or through

Virtual Inventory

Digital media technologies are also changing the risk profiles of both distributors and content owners. Old media distribution models often involved retail outlets. The media would be stocked in stores by retailers, with titles going out-of-circulation rather quickly as old titles were displaced from retailer’s shelves by new titles. Today, companies manage a virtual inventory as printed materials, CDs, and DVDs migrate to digital formats. This lengthens the life cycle of content. Now, content is available for longer periods of time as the opportunity cost of holding an older title in ‘digital’ inventory is lower online (compared to retail stores where older titles occupy valuable shelf space). As the economic life of content lengthens, does this increase the value of the content itself or of the distribution network? This raises another interesting issue requiring resolution when considering the appropriate transfer price or allocation of profits between content owners and distributors.

Advertising Sales

As previously stated, one of the revenue sources of digital content distribution is advertising, where content is supplied to the consumer free of charge with revenues derived from the sale of advertising space. Advertising sales is the term used to define the selling of advertising space, be it on websites, TV channels, or magazines. Transactions involving advertising sales can be quite complex. From a planning perspective, advertising sales have the potential to earn significant profits. The transfer pricing challenge, however, is making sure that those profits are properly allocated to the other elements of the supply chain. An advertising revenue model must still compensate the content producer as well as the distributor and/or aggregator.

In truth, advertising sales are often a routine function that can be priced internally using CUTs. Independent advertising agencies and representatives are plentiful. For its efforts, the third-party advertising representative is given a percentage of the net advertising sales' revenues or a commission. In other words, the advertising representative is only paid after the advertising agency is compensated. Transactions with third-party advertising representatives, if available, should be examined as potential CUTs for setting or testing a transfer pricing policy.

Another consideration is how to associate advertisements with specific titles or programming content. Take, for example, a website where content is made available for free with revenues generated solely from advertising. Is it possible to tie each advertising slot to the content in question? Content owners earn revenue based on the strength of the entire content portfolio. Therefore, it is nearly impossible to determine the profit associated with each specific title. Transfer pricing policies must consider the functions and risks associated with network distribution rather than relying on the licensing of individual titles.

Bundling

When determining the appropriate level of remuneration to the media distributor, it is important to consider whether an analysis that utilizes a bundled approach is appropriate. Film studios undertake motion picture projects with an eye toward multiple channels of distribution. Upfront investments in these projects are substantial and, in many cases, could not be justified based on theatrical sales alone. Motion picture films frequently earn a small profit (or incur a loss) during their theatrical release due to large upfront costs. In general, films will earn the bulk of their profit when they are distributed in the downstream channels of home entertainment, television, and eventually the internet. This pattern can even be true of blockbuster films. As previously mentioned, one of the more significant upfront costs in the motion picture industry are the promotional expenses that occur immediately before and during the theatrical distribution phase. Marketing expenditures are concentrated during a film's theatrical release because successful theatrical marketing creates demand at the box office, which then influences the film's future reception and value in the downstream distribution channels such as home video and

“Transfer pricing policies must consider the functions and risks associated with network distribution rather than relying on the licensing of individual titles.”

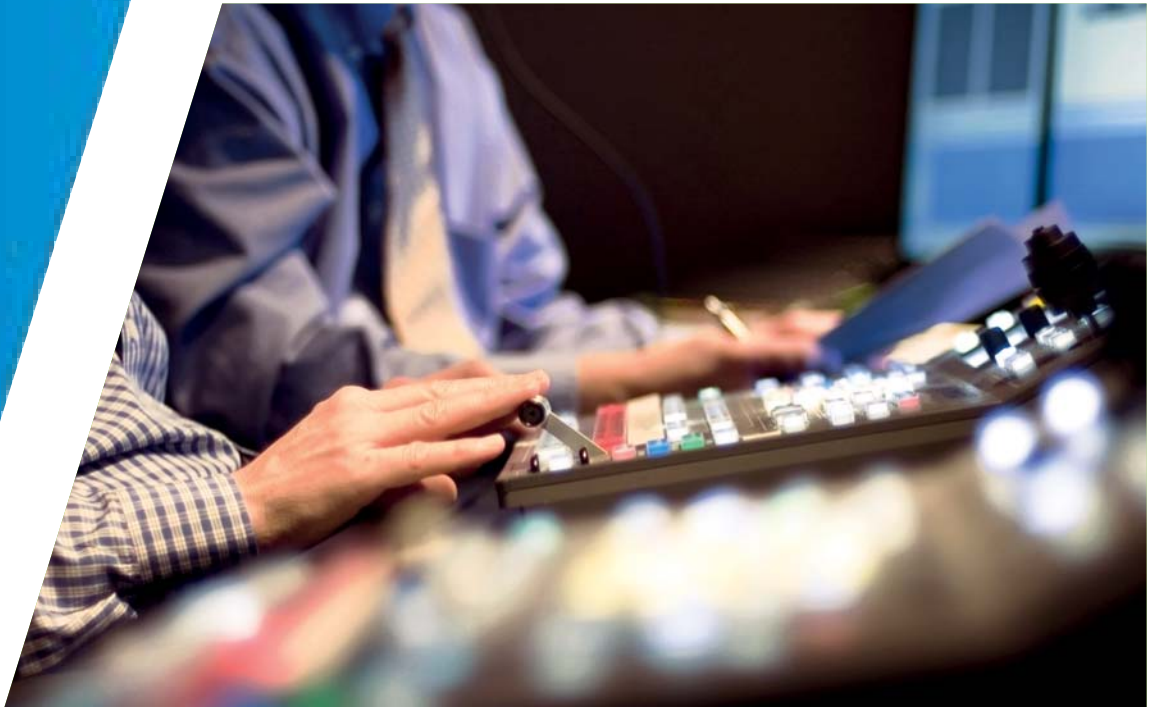
television. In the age of digital media, what does this mean? How would the bundling of transactions work across different distribution mediums when content is eventually provided to the consumer downstream without a charge via free TV? What is the relative value to each distribution channel and how do the functions and risk profiles for the different mediums compare? While it may make economic sense to aggregate the total return at the box office, home entertainment, pay-television, and internet levels in order to evaluate the profitability of a distributor, there may be practical obstacles to doing so.

Europe Snapshot

- **In light of the recently issued** update of the OECD Guidelines, local tax authorities will be watching the value chain shifts and preparing to react if they feel profits are being moved offshore without good commercial reason. There are risks here, because the OECD has so far offered little guidance on tax and convergence.
- **Most OECD countries have media** ownership policies exerted through regulation and licensing (for example broadcast licenses). In some markets however, the possibility of greater concentration of ownership within and between media has increased.
- **The digitization of film and video** content increases the technology intensity of the industry. All OECD countries offer various forms of research and development support, ranging from tax incentives to subsidies and such schemes are applied to a wide range of technologies, many of which are relevant to the further development of the digital audio-visual environment.

Conclusion

The emergence of digital media has generated exciting and challenging opportunities throughout the media and entertainment industry. Changes in any value chain generate complex mixtures of risks and opportunities for tax planning and are thus likely to attract the attention of local fiscal authorities. Companies should recognize that it's far easier to manage the tax and transfer pricing risks associated with planning opportunities at the outset, than after new models are established. The ideal time to review the value chain of the business, and the transfer pricing policies that underpin it, is when designing a new, or adapting an existing business model. The challenge is to build a transfer pricing model reflecting commercial objectives that is defensible and is supported by robust documentation, policies and controls. Such a policy should identify the key value drivers and apply transfer pricing methodology to the key functions, risks and assets used by a business. **Although it might seem dull or inconsequential to the business, a full transfer pricing analysis is needed for the successful adoption of any new business model, only by doing this can tax planning appropriately support business model changes and thereby preserve the benefits of the exciting new business transformations arising from convergence on an after-tax basis.**



A close-up, profile view of a man's face on the right side of the image, looking towards the left. He is smiling slightly. In the background, a computer keyboard is visible, with keys in various colors (white, blue, red, green). The image is overlaid with several horizontal bars of different colors, each containing a portion of a quote in bold, dark grey text.

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